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# Foreign Direct Investment, Financial Development and Political Risks

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## Abstract

Financial development is definitely a determinant of the extent of foreign direct investment (FDI) inflow into an economy. Yet, the contribution of financial development (FD) can be dependent on the political situation of the recipient nation. Higher political stability aids financial institutions to reap the benefits of FDI efficiently. Our paper empirically investigates the role of political risk in the association of FDI and FD. Using a panel of 97 countries, we show the relationship to be strictly non-linear. The impact of FD on FDI becomes negative beyond a threshold level of FD. However, we do find political risk factors to be affecting the relationship by altering the threshold level of financial development.

*JEL Classification: C23; F23; O16*

*Key Words: Foreign Direct Investment, Financial Development, Political Risks.*

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## **I. Introduction**

Financial Development is an integral component of the growth process of an economy. According to Beck, Demirguc-Kunt and Levine (2000), financial development indicators measure the size, activity and efficiency of financial intermediaries and markets. The indispensable role of financial system has been accepted by economists like Schumpeter (1912), Hick (1969) and McKinnon (1973). In Schumpeter's words, "The banker... is not so much primarily a middleman in the commodity 'purchasing power' as a *producer* of this commodity...He stands between those who wish to form new combinations and the possessors of productive means. He is essentially a phenomenon of development, though only when no central authority directs the social process. He makes possible the carrying out of new combinations, authorizes people, in the name of society as it were, to form them. He is the ephor [overseer] of the exchange economy."(Schumpeter, 1934, p174). King and Levine (1993a, 1993b, 1993c) and Levine (1997) re-established the importance of efficient financial markets during recent times. Apart from having a first order impact on growth, financial development also affect other aspects of economic development. Financial development can make foreign aid work better for aid recipient countries (Nkusu and Sayek, 2004). Further, Beck (2002) has proved that countries with an effective financial sector have a comparative advantage in manufacturing industries. An agreed view of the functions of financial development identify the following functions – channelizing resources efficiently, mobilizing savings, reducing information asymmetry problem, facilitating trading, hedging, pooling and diversification of risk, aiding the exchange of goods and services and monitoring managers by exerting corporate control.

We revisit the links between financial development and foreign direct investment (FDI). Previous literature has already explored the connection in the context of growth (Hermes and

Lensink, 2003). Another strand of literature has attributed the uneven distribution of financial development to the political stability of the respective nations (Roe and Siegel, 2007). They argue that political stability is crucial for a nation since it helps build institutions such as investor protection which, in turn, aids the financial sector. Hess (2004) argues that firms are willing to invest in nations which experience political stability. Yet, no literature has explored the interlinkage among political risks, FDI and FD. The main contribution of the paper is to investigate the role political stability plays in enhancing the relationship shared by FDI and FD.

Is it sufficient for a country to have competent financial markets to lure foreign capital? We argue that a stable political scenario is critical to attract FDI even in the presence of an efficient financial sector. Using a panel of 97 countries over a period of 20 years, the results establish a non-linear association between financial development and FDI inflows. Financial Development leads to greater FDI inflows up to a certain level of financial development. Beyond that the association becomes negative. But the presence of higher political stability adds a different flavor to the relationship. With higher political stability, the negative impact sets in at relatively higher levels of financial development. Thus, the co-existence of competent financial markets and political stability is absolutely necessary to capture and utilize the benefits of FDI.

Section II explores the connections between financial development and FDI inflow and the role played by political risk in this context. Section III describes the data used in the paper. Section IV presents the benchmark results alongside reconfirming the non-linear association. In Section V we run the specifications by introducing political risk factors. Section VI talks about the various robustness analysis and Section VII summarizes.

## **II. Exploring the Linkages**

The prospects of development for economies, especially the emerging markets and the developing world, are dependant largely on their potentials to make profitable investments and also to accumulate capital. In the absence of unlimited resources and proper infrastructure, foreign capital seems to be the sole way out for these economies. Yet, some types of capital investments like short-term credits and portfolio investments are riskier since they cannot recover back quickly during periods of financial crisis. Since foreign direct investment has the greatest advantage in this respect, countries should try to attract such investment flows as part of their development plans (Prasad et. al., 2003). Realizing the importance of FDI inflows, the developing world and transition economies have responded quickly since the 1990s and foreign investments have reached enormous figures since then. According to IMF sources, FDI inflows to developing countries increased by an average of 23 percent a year during the period 1990-2000.

Should a host country incorporate FDI as part of its development project? The answer solely depends on the amount of positive spillovers (externalities) generated by FDI inflows for the host country. It is agreed that the spillovers are generated through technological diffusion and also to some extent, through knowledge creation. These spillovers are generally in the form of firm-specific assets (Markusen, 2002) like enhanced marketing strategies, superior management or production techniques, enhancement of private capital formation (Ramirez, 2006). Recent literature points out that multinational firm can also generate pecuniary externality for the firms in the host country (Markusen and Venables, 1999). Such externalities are generated via reduction in cost or increased revenues. The spillover effects, in turn, have positive impacts on the growth of an economy. Knowledge spillovers are usually in the form of imitation of technology and technical know-how. Researches have proved that factors like better financial

development, greater human capital and higher trade openness enhance the positive relationship between FDI and growth (Balasubramanyam, Salisu and Sapsford, 1996; Alfaro et. al., 2003; Hermes and Lensink, 2003).

This paper initially explores the direct linkages between financial development and FDI inflows. It reestablishes the positive association between the two. Hermes and Lensink (2003) investigate the association of FDI and growth in a cross sectional set up. They have come up with several justifications as to why a developed financial system should have a positive impact of FDI. A developed financial system mobilizes savings efficiently which, in turn, expand the amount of resources available to finance investment. Also, it filters and monitors investment projects by reducing information acquisition costs. Financial development also speeds up adoption of new technologies by minimizing the risk associated with it. With developed financial infrastructure, the foreign firms are able to judge how much they can borrow for innovative activities and are able to make ex-ante planning about their investments. Financial development also increases liquidity and, thus, facilitates trading of financial instruments and timing and settlement of such trades (Levine, 1997). This will also lead to greater FDI inflows as the projects can be undertaken with lesser time being spent in settling the trades. We, further, hypothesize that the relationship is strictly non-linear. Rioja and Valev (2004) also proved the existence of non-linear relationship between FDI and growth. The association between financial development and FDI inflows is positive after a threshold level of financial development is reached<sup>1</sup>. Better financial institutions attract greater foreign capital. But, for significantly higher levels of financial development, the impact is negative. Once the country reaches substantially higher levels of financial development, lesser and lesser foreign investment is needed to boost

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<sup>1</sup> Overall financial development and FDI have a concave relationship. At very low levels of financial development, the relationship becomes ambiguous. For such levels of financial development, firms suffer from constrained cash flows and, thus, cannot attract greater FDI inflows (Rioja and Valev, 2004). The relationship is ambiguous in the sense that FDI inflow occur due to factors other than financial development.

the economy. Domestic investment is adequate to sustain and pace up the growth rate of such economies.

Levine (1997) admits that financial markets work in conjunction with institutions and that the latter has an important role to play in the performance of the former. Using cross country regressions, Kapuria-Foreman (2007) finds that certain components of economic freedom are positively affected with foreign direct investment. Keeping such observations in mind, we delve deeper into the role played by political risks in enhancing or degrading the association between financial development and foreign direct investment inflows. There have been several cross-country studies based on international data regarding the impact of policy-related variables like intellectual property protection, corruption and institutional uncertainty on FDI inflows (Lee and Mansfield, 1996; Brunetti and Weder, 1998; Wei, 2000). Recently, several studies have studied the impact of democratic institutions on FDI inflows. While one strand of thought shows the relationship to be positive (Harms and Ursprung, 2002; Jensen, 2003; Busse, 2004), Li and Resnick (2003) argue that there is more to the relationship. Though democratic right has an indirect boosting impact on FDI inflows by improving property rights protection, the direct impact on FDI is negative. Busse and Hefeker (2005) show in their study that some aspects of political stability like government stability, the absence of internal and external conflicts, basic democratic rights and an efficient law and order system, matter significantly in determining FDI inflows. They show that foreign investors are susceptible to changes in political stability of an economy.

According to the law and finance literature, institutions that provide investor protection have been proved crucial for financial development. According to Roe and Siegel<sup>2</sup> (2007), an

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<sup>2</sup> There are many explanations as to what generates investor protection which, in turn, aids the formation of efficient financial infrastructure. La Porta et al (1997, 1998) and Beck, Demirguc-Kunt and Levine (2001) claim that legal origin is key to investor protection and, thus, to financial development. Common law nations are crucial for financial

economy's capacity to develop and foster investor protection is largely dependent on the political stability scenario. They argue that unstable governments cannot credibly commit to policies that can encourage and foster entrepreneurial functions, saving and functioning of the financial markets. They, further, argue that political instability can bring about poor macroeconomic policy and, thus, can hamper the development of financial infrastructure. Thus, the role of political stability cannot be ignored while investigating the association between financial development and FDI inflows. Political risk seems to be crucial from the aspects of both financial development and inflows of foreign capital.

A better functioning financial market is critical for determining the amount of FDI inflows to a nation but is not sufficient. Political stability is absolutely necessary along with financial competence for attracting foreign investors. Political stability will ensure that there are less expropriation risks and government can credibly commit to aid the functioning of financial market. It will accelerate the adoption of new technologies and also internalize the spillovers. These enhance investor confidence in the host country and bring in more foreign capital. A decent level of financial development in the presence of high political instability will actually achieve little in terms of FDI inflows. We cite a couple of evidences from the raw data as support to our hypothesis. Chile has a good score for financial infrastructure. Yet, during the mid eighties, it had relatively high levels of political risks in the form of unstable government, high risks associated with investment and strong involvement of military with politics. As a consequence, FDI inflows were lower for those years. As political stability was achieved over the later years, there was greater influx of FDI into the country. Again, for Malta both levels of

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outcomes since they provide investor protection while civil law nations suffer from financial inefficiency. Rajan and Zingales (2003) show that trade openness can explain the stark variation in financial development across nations. They argue that special interest groups have strong incentives to block the development of a transparent and competitive financial sector. Yet, those incentives may be weakened with the opening of international trade and the international flows of capital. Colonial origins form the basis for another set of explanations. According to Acemoglu, Johnson and Robinson (2001), colonial origins determined earlier institutional structure and are the sole factors that matter for an efficient financial system.



financial development and political stability seem to be essential for foreign direct investments. The amount of FDI inflows went up from a meager 2.46 units as a percentage of GDP in 1984 to 20.16 units in 2003. There was improvement in financial infrastructure (the figures went up from 0.47 to 1.05) but greater political stability was also achieved during the same period. While government stability went up from 7 to 10.5, investment profile went up from 7 to 11.

### **III. Data**

The data used for analysis has been taken from various sources. The data on FDI, the dependent variable, is taken from the United Nations Conference on Trade and Development (UNCTAD) database. The measure considered is FDI inflow to a country as a percentage of Gross Domestic Product (GDP)<sup>3</sup>. The primary independent variable namely “financial development (FD)” has been taken from the Beck, Demirguc-Kunt and Levine (2000) database of indicators of financial development across countries over time. Amongst the various measures of financial development listed in the article we mainly use the ratio of private credit by deposit money bank to GDP. This is the most widely used measure of financial development and captures one of the main activities of financial intermediaries, namely, channelizing savings to investors. Furthermore the measure accounts for credit issued to the private sector (as opposed to government and public enterprises) by intermediaries other than Central Bank. Later for robustness checks we use other measures of financial development from the dataset namely the ratio of private credit by deposit money banks and other financial institutions over GDP. This accounts for the activities of financial intermediaries. We further use domestic credit provided by the banking sector as a percentage of GDP and domestic credit to private sector as a percentage of GDP as measures of financial

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<sup>3</sup> We consider alternative data sources for FDI later.

development. Both these measures are taken from the World Development Indicator (WDI) database.

Besides financial development, we use several other explanatory variables for our main regression. Annual growth of GDP<sup>4</sup> (Nonnemberg and Mendonca, 2004) and population are taken from World Bank World Development Indicators (WDI) 2005. An increased population definitely leads to diversification in tastes and preferences and a look out for a variety of high standard opportunities, which in an era of globalization is well catered to by FDI. Inflation and exchange rate (Froot and Stein, 1991; Garibaldi et al, 2001) are taken from the Penn World Table. Both of these definitely have a strong impact on FDI inflows since their stability decides how lucrative the destination country is for the inflowing FDI. Exchange rate gained prominence with the study of Froot and Stein (1991), who, in an imperfect capital market showed how currency depreciation leads to increased foreign investment inflow. To control for openness (Nonnemberg and Mendonca, 2004) we rely on data from the Penn World Table. We take the value of openness in 2000 constant prices where openness is defined as total trade as a percentage of real GDP per capita. To check for robustness we later include natural resources and secondary years of schooling as our control variables. The former is taken from the Sachs and Warner database while the latter from the Barro and Lee (2000) dataset.

Finally we use regional dummies as additional regressors to avoid any regional bias. The regional dummy variables considered are Middle East and North Africa (MEN), South East Asia (SAR), East Asia and Pacific (EAP), Europe and Central Asia (EAC), Sub-Saharan Africa (SSA) and Latin America and the Caribbean (LAC). We control for time effects in our specification.

To further our analysis we use various country specific political risk indicators from the International Country Risk Guide (ICRG) database. These in conjunction with financial

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<sup>4</sup> Since both the FDI and FD measure are with respect to GDP, we do not use GDP as a control variable.

development helps us not only to analyze the causal connection better but also in having a fair idea about which risk factor matters more. The variables taken into account are government stability, democratic accountability, law and order, investment profile, corruption, bureaucratic quality, ethnic tension, socio-economic condition, internal conflict, external conflict, military in politics and religious tensions. Each of these variables has a particular range of values assigned to it and higher values signify better condition.

Borenstein et. al (1992) tested the effect of FDI on economic growth using cross country regressions for 69 developing countries. De Gregorio (1992) found a significant impact of FDI on growth using a panel analysis of 12 Latin American countries while Blomstrom et al (1996) found the same using a panel of least developed nations. De Mello (1996) employed both time series and cross section analysis to establish the complementarity between FDI and domestic investment. Calvo and Sanchez-Robles (2002) have delved into the interlinkages among FDI, economic freedom and economic growth. According to them<sup>5</sup>, panel approach is relatively better than cross section analysis since it takes into account the variability within countries and also “allow for differences in production function of the various nations in the form of unobservable individual effects”. Thus, we undertake a pooled OLS<sup>6</sup> estimation for a panel of 97 countries over the years 1984 to 2003. We use Feasible Generalized Least Square (FGLS) as part of our robustness analysis.

#### **IV. The Empirical Assessment**

The primary regression specification is as follows

$$FDI_{it} = \beta_0 + \beta_1 FD_{it} + \beta_2 FD_{it}^2 + \beta_3 X_{it} + \beta_4 REGIONAL + \beta_5 Z_t + \varepsilon_t \quad (1)$$

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<sup>5</sup> Islam (1995) and Fölster and Henrekson (2001) also talk about the efficiencies of a panel approach.

<sup>6</sup> Following previous literature, we have also checked the robustness of our findings by running both cross-country and 5 year panel regressions. Our results remain unaffected with the alternate specifications.

Where  $FDI_{it}$  is the ratio of FDI inflow over GDP for country  $i$  at time  $t$ .  $X_{it}$  represent the matrix of control variables. The control variables are annual growth of GDP, inflation, exchange rate, trade openness and population.  $REGIONAL$  stands for the vector of regional dummies and  $Z_t$  is the vector representing time dummies. The independent variables of primary interest are  $FD_{it}$  and  $FD_{it}^2$  representing financial development and its square (in country  $i$  at time  $t$ ) respectively. As mentioned earlier, financial development is proxied by the ratio of private credit by deposit money bank to GDP. The squared term of financial development captures the non-linearity in the relationship between financial development and FDI inflow. A positive coefficient of FD should denote that financial development has a positive impact on FDI inflow. However a negative coefficient of the square term will denote that the effect declines for higher levels of financial development. This is infact what is shown by the data. The benchmark results are given in Table (1).

The estimation results show that  $\beta_1$  is positive and significant at the 1% level while  $\beta_2$  is negative and significant at the 5% level. Thus we find a strictly concave relation between financial development and FDI inflow<sup>7</sup>. However after a threshold is reached, financial development and FDI inflow become negatively related. Annual growth rate of GDP and openness have positive coefficients which are significant at the 1 % level. Exchange rate has negative coefficient which is significant at the 1 % level. The coefficients for regional and time dummies are mostly significant. To interpret the result further, we consider the partial derivative of equation (1) with respect to financial development (FD). The derivative is defined as follows

$$\frac{\partial FDI_{it}}{\partial FD_{it}} = \beta_1 + 2\beta_2 FD_{it} \quad (2)$$

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<sup>7</sup> Throughout the relationship we observe diminishing returns. This implies the change in FDI inflow always diminishes for every unit change in FD.

Setting this equal to zero, a critical level of financial development can be identified. At this level, financial development has no impact on FDI inflow relative to GDP. From the first regression, this level can be identified to be 1.3. Figure (1)<sup>8</sup> represents the relationship. Before financial development reaches a level of 1.3, FD has a positive impact on FDI inflow. Beyond this threshold<sup>9</sup>, further improvement in financial development is seen to have a negative impact on FDI inflow.

We further our analysis by breaking our sample on the basis of levels of financial development. We consider the top, middle and bottom 33% of the sample, sorted according to the levels of financial development and look at how FDI inflow relates to financial development at its various ranges of development. The results (not reported) show that the strictly concave relation between financial development and FDI inflow is maintained in the top 33% of the sample. The result for the middle 33% sees a relaxation of the strict concavity. Here we observe a positive linear relation between the two. The result for the bottom 33% of the sample is rendered unclear.

## **V. The Role of Political Risk Factors**

To explain, further, the observed non-linearity between financial development and FDI inflow and the variation for the altering ranges of financial development, we introduce political risk factors in our analysis. This helps us explore whether the levels of political risks play a role in the ability of a country to use the financial development to its advantage and reap its benefits by attracting more FDI. For this we alter our regression specification as

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<sup>8</sup> We plot the relationship between FDI and FD for different levels of political risks. For the control variables, we consider the average values. The regional dummies are given the weights according to their proportion in the total sample. The year dummies are equally weighted.

<sup>9</sup> Beyond  $FD = 1.3$ , FDI is still positive but an unit rise in FD leads to less than an unit decline in FDI over GDP.

$$FDI_{it} = \beta_0 + \beta_1 FD_{it} + \beta_2 FD_{it}^2 + \beta_3 POL\ RISK_{it} + \beta_4 (FD_{it} * POL\ RISK_{it}) + \beta_5 X_{it} + \beta_6 REGIONAL + \beta_7 Z_t + \gamma_{it} \quad (3)$$

We include all the twelve ICRG variables into our analysis individually to gauge which all are important in enabling a country to take financial development in its stride and attract more FDI. In our new specification, the sign and significance of  $\beta_4$  matters the most. A positive and significant  $\beta_4$  would imply that for a given level of political risk, higher FD implies higher FDI. For given levels of political risk we have a concave association between the two. With higher and higher political stability, the concave curve shifts upward and the critical level, beyond which the impact is negative, corresponds to even higher levels of FD. This is depicted in figures later. For example, Fig 2(A) represents the graphs with government stability (GS) as the risk factor. For GS equal to 2, the curve always slopes down implying that higher financial development does not help in attracting more FDI. But as the score rises to 6.5 and then to 10.5, the curve shifts upward and we have positive segments in the concave plots. Similarly, for the other political risks (Figs 2(B) to 2(G)), as the scores the curves shift upwards we have positive slopes over broader ranges of financial development.

The results depict that out of the twelve political risk factors identified by ICRG, five namely, Government Stability, Law and Order, Investment Profile, Bureaucratic Quality and Socio-economic Condition have positive coefficients, significant at the 1% level. Military in Politics and Religion in Politics also have positive coefficients and are significant at the 5% level. Of the other variables the coefficients for annual growth rate of GDP, exchange rate and openness are found to be significant for all the specifications. The results are summarized in Table (2).

For all the seven political risk factors mentioned above, we calculate the threshold level of financial development beyond which (as shown by our first main regression) it has a negative effect on FDI. We derive the derivative of FDI with respect to FD as

$$\frac{\partial FDI_{it}}{\partial FD_{it}} = \beta_1 + 2\beta_2 FD_{it} + \beta_4 POL\ RISK_{it} \quad (4)$$

By setting equation (4) equal to zero, and allowing for different levels of the various political risk factors, we derive the altering threshold level. We assign several random values (within each one's range) to these political risk factors and estimate how the threshold financial development alters accordingly. For all the factors, we unanimously find that improving political risk condition pushes the threshold level further. This implies that, as political risk gets better, the point at which the level of financial development has no effect on FDI inflow (i.e. where the slope becomes zero) gets relegated to even higher ranges of financial development. So, we can say that a better political risk scenario helps reap the benefits of a developing financial sector better and sustaining them over a broader range of financial development. In what follows we present our finding with each of the seven important factors separately. We bear in mind that in our sample, the value of financial development varies from 0 to 2.5 (with higher values representing higher levels of development).

#### *Government Stability*

This assesses the government's ability to stay in office and successfully meet its commitments. It consists of government unity, legislative strength and popular support. The score for this factor ranges from 0 to 12, where 0 points to "Very High Risk" and 12 means "Very Low Risk". To derive the various threshold levels of financial development corresponding to the altering levels of government stability, we choose various random levels of government stability within its range. We essentially choose the numbers such that it adequately represents the whole range of

the factor. When the score is 2, the impact of *FD* on *FDI* is always negative. As the score rises from 2 to 6.5 to 10.5, the threshold level for financial development rises first to 0.69 and then to 1.32 respectively. In the graphs the calculated thresholds correspond to the levels of financial development for which the slope becomes zero. In other words, the tipping points of the graphs refer to the thresholds. (See Figure 2A).

#### *Law and Order*

This factor, as the name suggests, consists of law and order separately. The total score of this range from 0 to 6 with higher values depicting “Low Risk”. We choose two random scores for law and order to be 1.5 and 5. The threshold for financial development in attracting FDI gets altered accordingly from 0.016 to 0.83 (See Figure 2B).

#### *Investment Profile*

This comprises of three factors (namely contract viability/expropriation, profits repatriation and payment delays) affecting the risk to investment, otherwise not captured by other political, economic and financial risk components. It ranges from 0 to 12 with higher values corresponding to “Low Risk Levels”. When we choose the level of investment profile to be 2, the threshold financial development needed to attract FDI is 0.12. When the score for investment profile improves to 6.5, the threshold level of financial development also goes up to 0.81. As the score for investment profile soars up to 10.5, the threshold for financial development reaches 1.43 (See Figure 2C).

#### *Bureaucratic Quality*

As ICRG states “... quality of the bureaucracy is another shock absorber that tends to minimize revisions of policy when governments change. ...Countries that lack the cushioning effect of a strong bureaucracy receive low points because a change in government tends to be traumatic in terms of policy formulation and day-to-day administrative functions”. The value of this factor



ranges from 0 to 4 with a higher value indicating “Lower Risk”. The threshold level of financial development rises from 0.04 to 1.14 as the score for Bureaucratic Quality changes from 1 to 3.5 (See Figure 2D).

#### *Socio-economic Condition*

This assesses the socio-economic tensions that impacts pressure at work of a society and constrains government action or leads to social discontent. This factor consists of unemployment, consumer confidence and poverty and ranges from 0 to 12 points, with a higher value indicating “Lower Risk”. Here, again for very low scores like 2 the impact of FD on FDI is always negative. As the socio-economic score changes from 6.5 and hence to 10.5, the threshold levels alters from 0.64 to 1.31 respectively (See Figure 2E).

#### *Military in Politics*

Involvement of military in politics is taken as a diminution of democratic accountability and is also seen to be an indication of an internal or external threat. The score for this factor ranges from 0 to 6 points with a higher value indicating “Lower Risk”. When the score for military in politics changes from 1.5 to 5, the threshold for financial development changes from 0.40 to 0.96 (See Figure 2F).

#### *Religious Tensions*

Religious tensions create rift among citizens and is a curse for the nation. It can be reflection of dominance of the government by any particular religion and suppression of the others and has the potential to initiate civil strife. The score for this factor ranges from 0 to 6, with a higher value indicating “Lower Risk”. With a level of religious tension at 1.5 the threshold for financial development lies at 0.07 while for a level of 5, the threshold moves up to 0.88 (See Figure 2G).

## VI. Robustness

We apply a number of robustness checks to ensure the validity of our results. Firstly, we control for infrastructural and technological improvements in our specification. This is following the literature by Loree and Guisinger (1995), Mody and Srinivasan (1996) and Kumar (2001) which emphasizes that physical infrastructure play a favorable role in attracting FDI into an economy. Following Kumar (2001) we use telephone mainlines per 1000 people and television sets per 1000 people as our proxies for telecommunication and information infrastructure. The results remain unaltered to the inclusion of this variable, both in the main specification as well as in the specification with ICRG variables. Our results remain robust with the inclusion of natural resource (Campos and Kinoshita, 2003) and secondary years of schooling (Borensztein et. al., 1995) as control variables.

We also consider other measures of financial development for robustness checks. Results with “private credit by deposit money banks and other financial institutions over GDP”, “domestic credit by banking sector as a percentage of GDP” and “domestic credit to private sector as a percentage of GDP” all confirm our results. With all three measures, the main regression renders the coefficient of  $FD$  to be positive and significant at the 1% level. The coefficient of  $FD^2$  is negative and significant at the 1% level for the first two measures and negative and significant at the 5 % level for the third measure. Interactions with ICRG political risk variables also confirm our previous findings. The same sets of variables are seen to be significant here.

We run diagnostic tests on our specifications where Durbin-Watson test identifies presence of autocorrelation. We correct the problem and generate more efficient estimates using Feasible Generalized Least Square Technique (FGLS). We apply this method to both the main specification as well as our extension with ICRG variables. The results are presented in column 2

of Table (1). For the main regression, the threshold value of financial development is still 1.3 and the coefficient is significant at the 1% level. The coefficient  $FD^2$  is significant at the 10% level. Annual growth of GDP, exchange rate and openness are still found to be significant at the 1% level.

When the ICRG variables are included, we find as before Government Stability, Law and Order, Investment Profile, Bureaucratic Quality and Socio-economic Condition to have positive coefficient significant at the 1% level. Military in politics, Religion in politics also have positive coefficients and are significant at the 5% level. In addition, we find Democratic Accountability to be positive and significant at the 5% level. When we now alter the scores of the political risk factors as before, the thresholds change identically, thus strengthening our findings. For Democratic Accountability, the threshold changes from 0.03 to 0.9 as the score is varied from 1 to 3.5. (See Table 3)

## **VII. Summary**

Foreign Direct Investment has been proved indispensable in the context of economic development. We contribute to this literature by exploring the role of political risks in the association between financial development and FDI inflows. Our results reveal that the association between the two is strictly non-linear. Beyond a critical level of financial development, the impact of financial development on FDI inflows is negative. But political stability seems to play a significant role in this context. For each level of political risk, there is a concave association between FD and FDI. Yet, with higher levels of political stability, financial development can absorb the benefits of FDI inflows in more efficient ways. Thus, each level of financial development is now associated with a higher level of FDI inflow. To state it more simply, the threshold level corresponds to higher and higher levels of financial development as

greater political stability is achieved. Some factors like stability of government, investment profile, and socioeconomic condition are comparatively more crucial than the others. Thus, an efficient financial infrastructure will achieve little in terms of attracting foreign investment, if the country suffers from political instability.

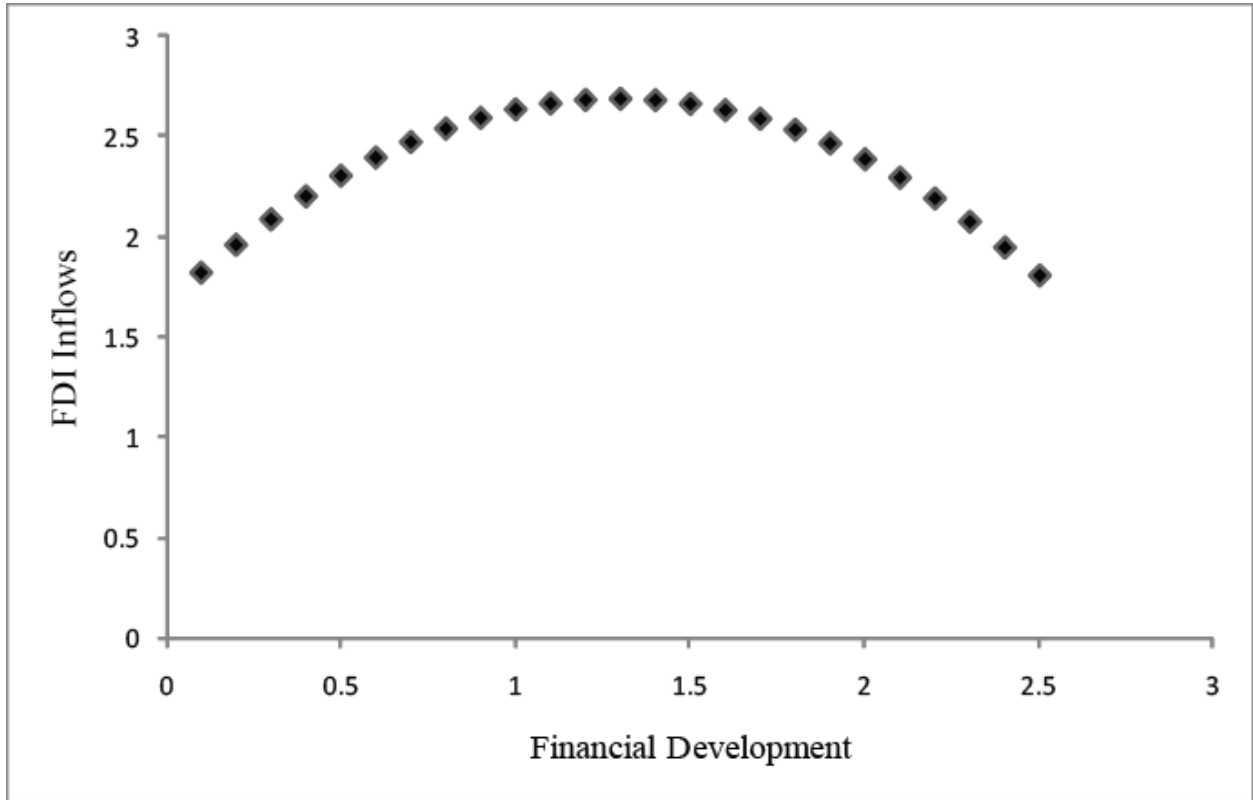
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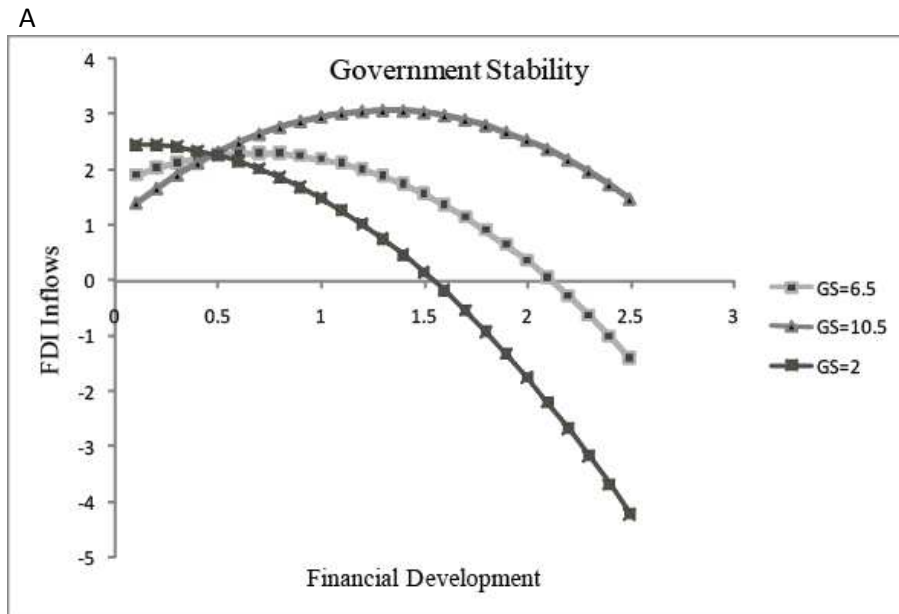
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**Figure 1: The Impact of Financial Development on FDI Inflows**

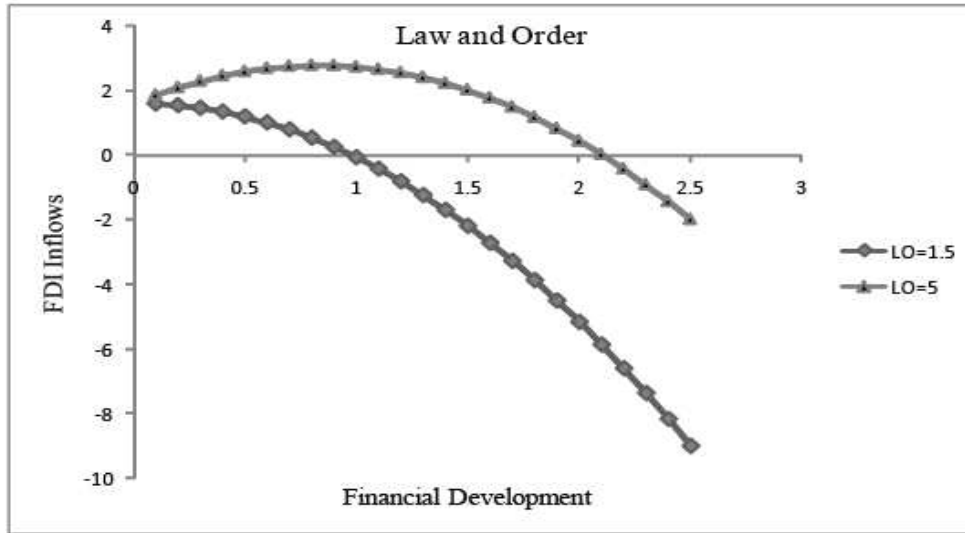


**Figure 2: The Impact of Financial Development on FDI Inflows for different levels of Political Risks**

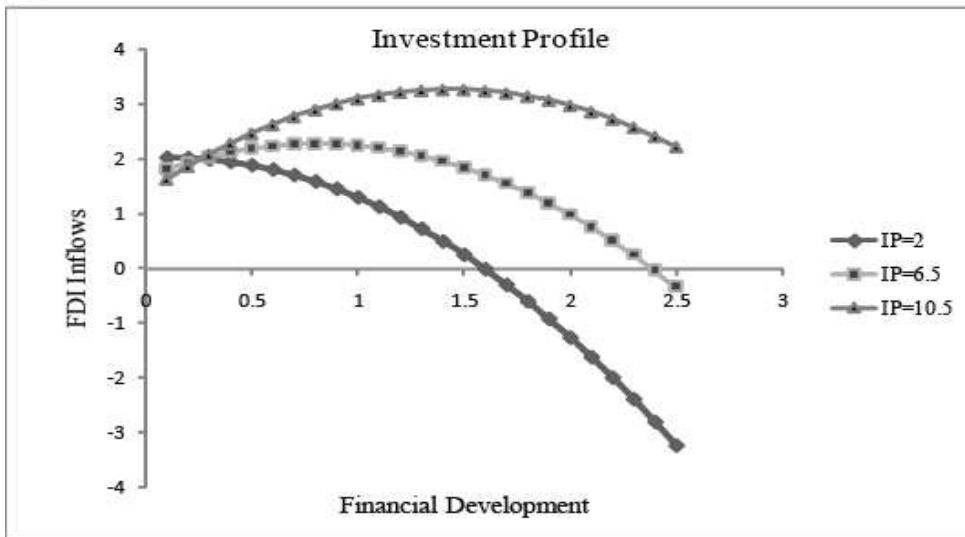




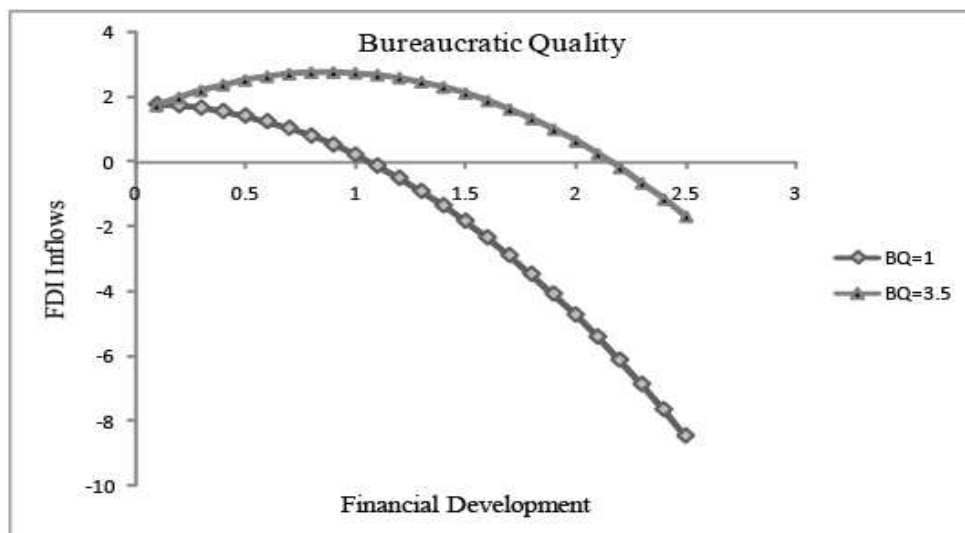
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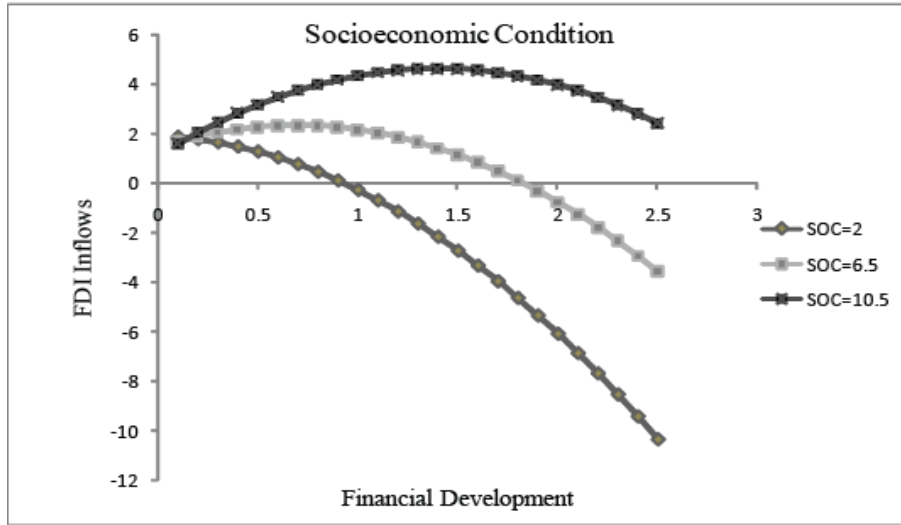
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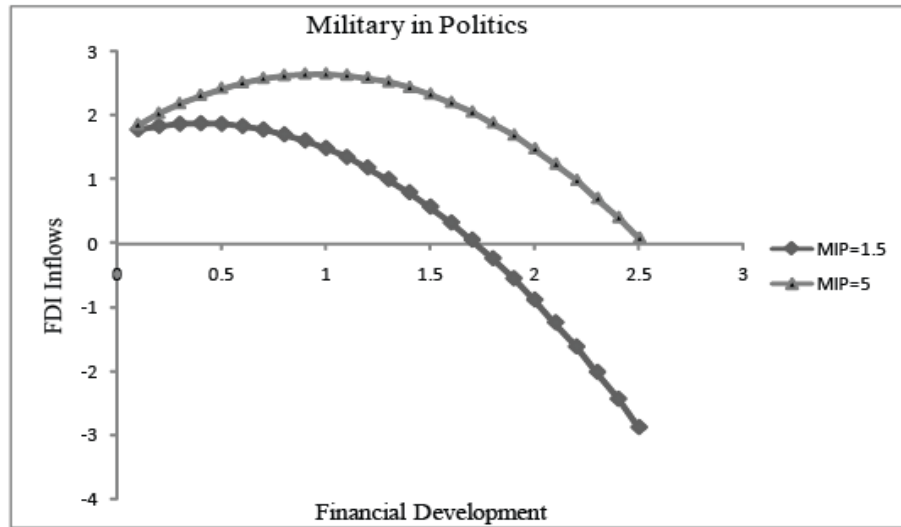
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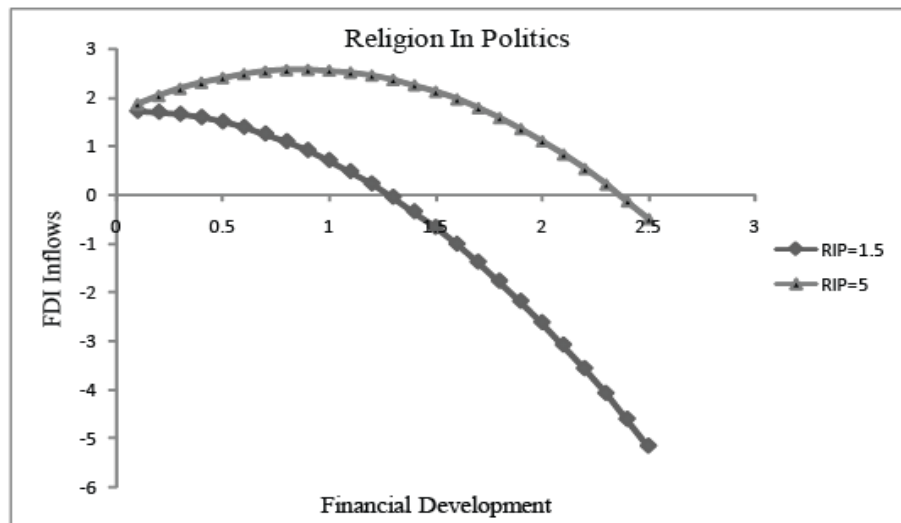
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**Table 1: OLS and FGLS showing the impact of Financial Development on FDI**  
 Dependent Variable: FDI Inflows over GDP

<i>Independent Variables</i>	<i>Estimates<sup>1</sup></i>	<i>t-statistics</i>	<i>Estimates<sup>2</sup></i>	<i>Z-statistics</i>
Growth	0.06*** (0.02)	3.31	0.06*** (0.02)	3.39
Inflation ( as a ratio of 100)	0.003 (0.005)	0.54	0.003 (0.02)	0.13
Exchange Rate (in \$0.001)	-0.002*** (0.001)	-3.23	-0.002** (0.001)	-2.15
Population (in billions)	-0.05 (0.36)	-0.12	-0.05 (0.77)	-0.06
Trade Openness	0.03*** (0.002)	11.26	0.03*** (0.002)	17.39
Dummy for Sub-Saharan Africa	-0.44* (0.25)	-1.71	-0.44 (0.28)	-1.54
Dummy for Latin America and the Caribbean	0.87*** (0.24)	3.59	0.87*** (0.25)	3.46
Dummy for Middle East and North Africa	-0.91*** (0.29)	-3.11	-0.91*** (0.26)	-3.49
Dummy for East Asia and Pacific	-0.44 (0.32)	-1.38	-0.44 (0.28)	-1.57
Dummy for South Asia	-0.79*** (0.24)	-3.27	-0.79* (0.44)	-1.82
Dummy for Europe and Central Asia	1.34** (0.62)	2.15	1.34*** (0.50)	2.67
Financial Development	1.58*** (0.60)	2.64	1.58** (0.74)	2.14
Financial Development <sup>2</sup>	-0.61* (0.33)	-1.87	-0.61 (0.46)	-1.33
Intercept	-0.21 (0.44)	-0.49	-0.21 (0.46)	-0.46
R - squared	0.33		---	
Chi - squared	---		782.33	
Observations	1572		1572	

Note: All regressions are run with robust standard errors. The Standard Errors are quoted in parenthesis. \*\*\* significant at 1% level; \*\* significant at 5% level; \* significant at 10% level. The year dummies have not been reported.

<sup>1</sup> Estimates for OLS

<sup>2</sup> Estimates for FGLS

**Table 2: Impact of Financial Development on FDI in presence of Political Risks**  
 Dependent Variable: FDI inflow over GDP

<i>Independent Variables</i>	(1)	<i>t-Statistics</i>	(2)	<i>t-Statistics</i>	(3)	<i>t-Statistics</i>	(4)	<i>t-Statistics</i>
Growth	0.06*** (0.02)	3.39	0.06*** (0.02)	3.17	0.06*** (0.02)	3.19	0.06*** (0.02)	3.27
Inflation (ratio of 100)	-0.003 (0.004)	-0.87	0.001 (0.001)	0.11	-0.001 (0.001)	-0.29	-0.001 (0.005)	-0.26
Exchange Rate (in \$0.001)	-0.002*** (0.001)	3.21	-0.002*** (0.001)	-3.21	-0.002*** (0.001)	-3.02	-0.002*** (0.001)	-3.09
Population (in billions)	0.02 (0.36)	0.06	-0.08 (0.38)	-0.20	-0.01 (0.37)	-0.02	-0.10 (0.40)	-0.26
Trade Openness	0.03*** (0.002)	11.15	0.03*** (0.002)	11.50	0.03*** (0.003)	11.04	0.03*** (0.003)	11.44
Financial Development	-0.72 (0.93)	-0.77	-1.16 (0.91)	-1.28	-0.36 (0.90)	-0.40	-1.01 (0.99)	-1.01
Financial Development <sup>2</sup>	-1.13*** (0.36)	-3.13	-1.71** (0.51)	-3.33	-0.92*** (0.34)	-2.70	-1.69*** (0.52)	-3.24
Political Risk	-0.16*** (0.06)	-2.62	-0.001 (0.10)	-0.01	-0.08 (0.07)	-1.12	-0.14 (0.13)	-1.06
Interaction	0.35*** (0.12)	3.02	0.80*** (0.26)	3.14	0.29*** (0.11)	2.71	1.14*** (0.37)	3.08
Intercept	1.02 (0.63)	1.62	-0.63 (0.52)	-1.21	0.12 (0.63)	0.19	-0.29 (0.44)	-0.67
R - squared	0.34		0.34		0.34		0.34	
Observations	1562		1562		1562		1562	

Note 1: All regressions are run with robust standard errors. The Standard Errors are quoted in parenthesis.  
 \*\*\* significant at 1% level; \*\* significant at 5% level; \* significant at 10% level. The regional and year dummies have not been reported.

Note 2:  
 (1) - Government Stability  
 (2) - Law and Order  
 (3) - Investment Profile  
 (4) - Bureaucratic Quality

**Table 2: Impact of Financial Development on FDI in presence of Political Risks (contd.)**  
 Dependent Variable: FDI inflow over GDP

<i>Independent Variables</i>	(5)	<i>t-Statistics</i>	(6)	<i>t-Statistics</i>	(7)	<i>t-Statistics</i>
Growth	0.06*** (0.02)	2.70	0.06*** (0.02)	3.30	0.06*** (0.02)	3.30
Inflation (ratio of 100)	-0.002 (0.004)	-0.48	0.001 (0.004)	0.29	0.003 (0.005)	0.58
Exchange Rate (in \$0.001)	-0.002*** (0.001)	-3.10	-0.002*** (0.001)	-3.12	-0.002*** (0.001)	-3.22
Population (in billions)	-0.09 (0.37)	-0.25	-0.15 (0.38)	0.39	0.14 (0.35)	0.41
Trade Openness	0.03*** (0.002)	11.13	0.03*** (0.002)	11.21	0.03*** (0.002)	11.79
Financial Development	-1.71* (0.98)	-1.75	0.34 (0.81)	0.42	-0.65 (1.16)	-0.56
Financial Development <sup>2</sup>	-1.81*** (0.48)	-3.76	-1.08*** (0.44)	-2.46	-1.16*** (0.45)	-2.56
Political Risk	-0.10 (0.07)	-1.43	-0.01 (0.07)	-0.16	-0.01 (0.07)	-0.16
Interaction	0.64*** (0.16)	3.88	0.34* (0.19)	1.80	0.54** (0.27)	2.03
Intercept	0.001 (0.49)	0.00	-0.35 (0.45)	-0.77	-0.39 (0.49)	-0.79
R - squared	0.35		0.34		0.34	
Observations	1562		1562		1562	

Note 1: All regressions are run with robust standard errors. The Standard Errors are quoted in parenthesis.  
 \*\*\* significant at 1% level; \*\* significant at 5% level; \* significant at 10% level. The regional and year dummies have not been reported.

Note 2:

(5) – Socioeconomic Condition

(6) – Military in Politics

(7) – Religion in Politics

**Table 2: Impact of Financial Development on FDI in presence of Political Risks (contd.)**  
Dependent Variable: FDI inflow over GDP

<i>Independent Variables</i>	<i>(5)</i>	<i>t-Statistics</i>	<i>(6)</i>	<i>t-Statistics</i>	<i>(7)</i>	<i>t-Statistics</i>
Growth	0.06*** (0.02)	2.70	0.06*** (0.02)	3.30	0.06*** (0.02)	3.30
Inflation (ratio of 100)	-0.002 (0.004)	-0.48	0.001 (0.004)	0.29	0.003 (0.005)	0.58
Exchange Rate (in \$0.001)	-0.002*** (0.001)	-3.10	-0.002*** (0.001)	-3.12	-0.002*** (0.001)	-3.22
Population (in billions)	-0.09 (0.37)	-0.25	-0.15 (0.38)	0.39	0.14 (0.35)	0.41
Trade Openness	0.03*** (0.002)	11.13	0.03*** (0.002)	11.21	0.03*** (0.002)	11.79
Financial Development	-1.71* (0.98)	-1.75	0.34 (0.81)	0.42	-0.65 (1.16)	-0.56
Financial Development <sup>2</sup>	-1.81*** (0.48)	-3.76	-1.08*** (0.44)	-2.46	-1.16*** (0.45)	-2.56
Political Risk	-0.10 (0.07)	-1.43	-0.01 (0.07)	-0.16	-0.01 (0.07)	-0.16
Interaction	0.64*** (0.16)	3.88	0.34* (0.19)	1.80	0.54** (0.27)	2.03
Intercept	0.001 (0.49)	0.00	-0.35 (0.45)	-0.77	-0.39 (0.49)	-0.79
R - squared	0.35		0.34		0.34	
Observations	1562		1562		1562	

Note 1: All regressions are run with robust standard errors. The Standard Errors are quoted in parenthesis.  
\*\*\* significant at 1% level; \*\* significant at 5% level; \* significant at 10% level. The regional and year dummies have not been reported.

Note 2:

(5) – Socioeconomic Condition

(6) – Military in Politics

(7) – Religion in Politics

**Table 3: FGLS showing the impact of Financial Development on FDI in presence of Political Risks**  
 Dependent Variable: FDI inflow over GDP

<i>Independent Variables</i>	(1)	<i>Z-statistics</i>	(2)	<i>Z-statistics</i>	(3)	<i>Z-statistics</i>	(4)	<i>Z-statistics</i>
Growth	0.06*** (0.02)	3.59	0.06*** (0.02)	3.17	0.06*** (0.02)	3.26	0.06*** (0.02)	3.24
Inflation (ratio of 100)	-0.003 (0.02)	-0.19	0.002 (0.02)	0.11	0.005 (0.01)	0.03	-0.001 (0.02)	-0.07
Exchange Rate (in \$0.001)	-0.002** (0.001)	-2.11	-0.002* (0.001)	-1.96	-0.002** (0.001)	-2.08	-0.002** (0.001)	-2.00
Population (in billions)	0.02 (0.77)	0.03	-0.02 (0.76)	0.02	-0.08 (0.77)	-0.10	-0.01 (0.77)	-0.01
Trade Openness	0.03*** (0.002)	16.87	0.03*** (0.002)	16.95	0.03*** (0.002)	17.36	0.03*** (0.002)	17.23
Financial Development	-0.72 (1.05)	-0.68	-0.07 (1.01)	-0.07	-1.16 (0.97)	-1.19	-0.36 (0.96)	-0.37
Financial Development <sup>2</sup>	-1.13** (0.49)	-2.34	-1.15** (0.57)	-2.01	-1.71*** (0.59)	-2.90	-0.92** (0.48)	-1.94
Political Risk	-0.16*** (0.06)	-2.75	-0.01 (0.09)	0.11	-0.001 (0.10)	-0.01	-0.08 (0.06)	-1.36
Interaction	0.35*** (0.11)	3.13	0.44** (0.23)	1.97	0.80*** (0.23)	3.49	0.29*** (0.09)	3.09
Intercept	1.02 (0.66)	1.55	-0.71 (0.57)	-1.26	-0.63 (0.54)	-1.15	0.12 (0.60)	0.19
Chi - square	797.14		793.47		818.86		795.01	
Observations	1562		1562		1562		1562	

Note 1: All regressions are run with robust standard errors. The Standard Errors are quoted in parenthesis.  
 \*\*\* significant at 1% level; \*\* significant at 5% level; \* significant at 10% level. The regional and year dummies have not been reported.

Note 2:  
 (1) - Government Stability  
 (2) - Democratic Accountability  
 (3) - Law and Order  
 (4) - Investment Profile

**Table 3: FGLS showing the impact of Financial Development on FDI in presence of Political Risks  
(contd.)**  
Dependent Variable: FDI inflow over GDP

<i>Independent Variables</i>	(5)	<i>Z-statistics</i>	(6)	<i>Z-statistics</i>	(7)	<i>Z-statistics</i>	(8)	<i>Z-statistics</i>
Growth	0.06*** (0.02)	3.39	0.05*** (0.02)	2.73	0.06*** (0.02)	3.42	0.06*** (0.02)	3.40
Inflation (ratio of 100)	-0.001 (0.02)	-0.06	-0.002 (0.02)	-0.11	0.001 (0.02)	0.07	0.003 (0.02)	0.15
Exchange Rate (in \$0.001)	-0.002** (0.001)	-2.04	-0.002** (0.001)	-2.04	-0.002** (0.001)	-2.03	-0.002** (0.001)	-2.11
Population (in billions)	-0.10 (0.77)	-0.13	-0.09 (0.77)	-0.12	-0.15 (0.77)	-0.19	0.14 (0.77)	0.19
Trade Openness	0.03*** (0.002)	17.71	0.03*** (0.002)	16.26	0.03*** (0.002)	17.02	0.03*** (0.002)	17.58
Financial Development	-1.01 (0.96)	-1.05	-1.71* (0.95)	-1.80	0.34 (0.94)	0.37	-0.65 (1.12)	-0.58
Financial Development <sup>2</sup>	-1.69*** (0.59)	-2.89	-1.81*** (0.53)	-3.42	-1.08* (0.57)	-1.91	-1.16** (0.52)	-2.25
Political Risk	-0.14 (0.12)	-1.12	-0.10 (0.07)	-1.41	-0.01 (0.07)	-0.16	-0.01 (0.09)	-0.14
Interaction	1.14*** (0.32)	3.62	0.64*** (0.13)	4.83	0.34* (0.20)	1.73	0.54*** (0.22)	2.45
Intercept	-0.29 (0.50)	0.58	0.001 (0.54)	0.00	-0.35 (0.50)	-0.71	-0.39 (0.58)	-0.67
Chi - square	805.72		828.61		787.93		795.97	
Observations	1562		1562		1562		1562	

Note 1: All regressions are run with robust standard errors. The Standard Errors are quoted in parenthesis.  
\*\*\* significant at 1% level; \*\* significant at 5% level; \* significant at 10% level. The regional and year dummies have not been reported.

Note 2:  
(5) – Bureaucratic Quality  
(6) – Socioeconomic Condition  
(7) – Military in Politics  
(8) – Religion in Politics



### Appendix 1: List of Countries

Algeria	Guatemala	Oman
Argentina	Guinea-	Pakistan
Australia	Bissau	Panama
Austria	Guyana	Papua New Guinea
Bahrain	Haiti	Paraguay
Bangladesh	Honduras	Peru
Belgium	Hong Kong	Philippines
Bolivia	Hungary	Portugal
Botswana	Iceland	Saudi Arabia
Brazil	India	Senegal
Burkina Faso	Indonesia	Sierra Leone
Cameroon	Iran	Singapore
Canada	Ireland	South Africa
Chile	Israel	Spain
Chi	Italy	Sri Lanka
Colombia	Jamaica	Sudan
Congo (K)	Japan	Sweden
Congo( B)	Jordan	Switzerland
Costa Rica	Kenya	Syria
Cyprus	Kuwait	Thailand
Denmark	Madagascar	Togo
Dominican	Malawi	Trinidad and Tobago
Republic	Malaysia	Tunisia
Ecuador	Mali	Turkey
Egypt, Arab	Malta	Uganda
Rep.	Mexico	UAE
El Salvador	Morocco	United Kingdom
Finland	Mozambique	United States
France	Netherlands	Uruguay
Gabon	New Zealand	Venezuela
Gambia, The	Nicaragua	Zambia
Germany	Niger	Zimbabwe
Ghana	Nigeria	
Greece	Norway	

## Appendix 2: Data and its Sources

Variables	Source
Foreign Direct Investment	UNCTAD( United Nations Conference on Trade and Development) and WDI 2005
Growth	WDI 2005
GDP per capita	WDI 2005
Inflation( annual domestic inflation rate)	WDI 2005
Population	WDI 2005
Exchange Rate	Penn World Tables
Political Risks	International Country Risk Guide(ICRG)
Schooling	Barro and Lee (2000)
Financial Development measures	Beck, Demirguc-Kunt and Levine(2000) dataset & WDI 2005
Trade Openness(exports + imports over GDP)	Penn World Tables
Political Risks	International Country Risk Guide( ICRG) database
Natural Resource	Sachs and Warner